

Request for Clarification: Chevron Corporation Section 25137 Petition

At the meeting of the Franchise Tax Board on June 27, 2001, the members considered a Section 25137 petition from Chevron, Inc. to provide so-called "factor relief" with respect to dividends received from certain 50-percent owned corporations. At the conclusion of the hearing, the Board adopted a motion to adjust Chevron's apportionment formula so as to "include 50 percent of the Caltex factors to better reflect Chevron's business in California." During discussions preceding the adoption of this motion, a number of alternative computations which would provide 50-percent factor relief were discussed. The motion the Board adopted did not specify which of the alternatives discussed should be employed in according relief under Section 25137.

In this request, staff asks the Board to resolve this ambiguity in a manner consistent with general unitary principles. Those principles require entities whose factors are utilized to apportion income to also include their entire pre-tax income, not just dividends, in the apportionment base. Staff's request, authored by Chief Counsel Brian W. Toman, is contained in an August 15, 2001 Memorandum to the Board which is attached. Also attached is Chevron's September 13, 2001 response. In its response, Chevron has ignored the number of alternatives that were in play and has characterized staff's request, sometimes in rather colorful terms, simply as reargument of Chevron's original petition.

Staff continues to recommend that there be no reduction in Chevron's tax liabilities beyond the amounts contained in the department's assessments because these assessments already reflect lower tax liabilities than would be the case if 50-percent factor relief were provided, coupled with full inclusion of pre-tax income as required under unitary tax principles. (Column 2 of the schedule accompanying staff's request.) Nevertheless, staff is fully cognizant of the fact that the Board did not adopt staff's recommendation and apparently intended to grant Chevron additional relief. Thus staff urges that the relief granted at least recognize the income/dividend distinction. (Column 4 of the schedule accompanying staff's request.) The alternative proposed by Chevron in Exhibit 45 of its petition (Column 5 of the schedule accompanying staff's request.) gives absolutely no recognition to this distinction, which is a basic principle of unitary law. (See, e.g., Cal. Code Regs., tit. 18, §§ 24345, subd. (b); 25106.5, subd. (c)(1))

Staff also wishes to again underscore the magnitude of the potential legal and financial impact of the Board's decision to grant relief here. These circumstances are not unique. At a minimum, the operations of the other major oil companies must also be considered. Virtually all of these companies now represent they have operations very similar to Chevron's Caltex operations. Petitions from these companies can be anticipated and they will be extremely difficult to distinguish on a factual basis from Chevron's petition here. Subsequent to the issuance of the Chief Counsel memorandum, staff has estimated the financial impact if these oil companies alone were to be granted relief utilizing Chevron's 50-percent methodology. Even without the data from two major oil companies (for which the figures were not readily available), the revenue impact would be approximately \$24.8 million in tax for all open years over and above the \$20.6 million Chevron itself will receive for post-petition years through 2000. With interest, the total revenue impact could well exceed \$90 million.



STATE OF CALIFORNIA
FRANCHISE TAX BOARD
PO Box 2229
Sacramento, CA 95812-2229
Telephone (916) 845-3307
FAX (916) 845-3191

KATHLEEN CONNELL
Chair

CLAUDE PARRISH
Member

B. TIMOTHY GAGE
Member

MEMORANDUM

To: Hon. Kathleen Connell, Chair
Hon. Claude Parrish, Member
Hon. B. Timothy Gage, Member
Franchise Tax Board

August 15, 2001

410:BFM:h\25137\Chevron Petition

From: Brian W. Toman

Subject: Request for Clarification: Chevron Corporation 25137 Petition
Income Years 1992-1995

Following a presentation at the Board's June 27 meeting, a motion was adopted to adjust Chevron's apportionment formula to "include 50 percent of the Caltex factors to better reflect Chevron's business in California." (Board Transcript, page 120, lines 17-19.) The motion was made by the Chair and was prefaced by the statement, "The Caltex companies are clearly part of Chevron's worldwide integrated oil business." (Board Transcript, page 120, lines 10-12.) In staff's view, the relief reflected in the motion adopted is inconsistent with the premise upon which it apparently was based. Therefore, staff submits this memorandum to request clarification of the manner in which the relief the Board granted to Chevron is to be implemented.

The normal consequences of concluding that activities of separately incorporated entities are part of a unitary business is to include **all** the net pre-tax income and **all** of the apportionment factors of those entities in a combined report. When the income and activities are those of a partnership, the proportionate share of the net pre-tax income and apportionment factors of the partnership are included in the combined report. In both cases, the proportion of the factors included in the combined report is based upon the pre-tax income included in the combined report.

In the instant case, staff has included only the dividend income received from the separate corporate entities in the combined report. Dividends represent only a portion of the income of the dividend-paying entity. First, dividends are paid from after-tax income and, second, dividends typically are only a portion of the after-tax income of the dividend-paying entity. In order to maintain the normal relationship between the amount of income included in the combined report and the apportionment factors included in the combined report, the apportionment factors need to be adjusted based upon the ratio of the dividends to the pre-tax income of the dividend payor.

The presentations at the Board meeting involved consideration of each of Chevron's alternatives, as well as two other alternative computations involving 50-percent factor relief advanced by staff. Staff did not make clear in its presentation exactly what the differences and consequences of these various alternatives were, and no specific alternative was expressly incorporated in the Board's motion. For that reason, staff requests clarification of the approved motion.

Attached is an Exhibit showing Chevron's total tax liability for 1992–1995 under various alternatives.

- Column 1 of the Exhibit represents Chevron's tax liability under normal unitary treatment, inclusion of 100% of the income and apportionment factors of the Caltex group.
- Column 2 of the Exhibit represents Chevron's tax liability if Chevron is allowed to treat Caltex as a partnership, inclusion of 50-percent of the Caltex income and factors.
- Column 3 of the Exhibit sets forth the assessments actually proposed by the department based upon including the dividends in the combined report, but reflecting none of the factors of the Caltex group in the combined report.
- Column 4 of the Exhibit represents Chevron's liability if the dividends are included and the Caltex factors are included based upon the ratio of the dividends to Caltex's pre-tax income.
- Column 5 represents Chevron's liability if Chevron is granted 50-percent factor relief based on ownership rather than income. Column 5 is the result of the approach argued for by Chevron in Exhibit 45 of its petition.
- Column 6 represents Chevron's liability if the dividends are excluded from the combined report.

Please note that all Caltex income and factor data have been supplied by Chevron and have not been audited. In fact, the Board should be aware that the Chevron Exhibit 45 calculations encompassed in Column 5 do not match the numbers that Chevron submitted as a summary schedule at the hearing, a further possible ambiguity.

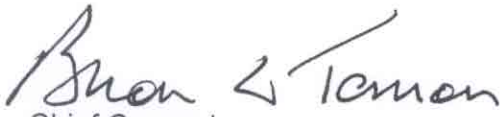
Staff continues to recommend that there be no reduction of Chevron's tax liability beyond the amounts stated in Column 3, the department's assessments. In effect, in the assessments proposed by the department, Chevron has already obtained relief (Compare Columns 1 and 2 with Column 3) because the proposed assessments included only dividends, not Caltex income and factors, in unitary group income. Staff would also point out that the difference between full combination (Column 1) and elimination of the dividends (Column 6) is approximately \$53 million and that the assessments proposed by the department allow the taxpayer almost \$30 million of this difference.

Nevertheless, the Board did not adopt staff's recommendation and apparently intended to grant additional relief. As noted, the stated premise upon which relief was granted is the *de facto* unity between Caltex and Chevron's other business operations. When corporations are part of a unitary group, however, the law clearly requires them to pay an apportioned tax based upon the **entire pre-tax income** of each unitary member, not upon just the dividends which a unitary member pays another unitary member.

The only 50-percent factor relief which staff believes fully reflects this relationship is Column 2 of the schedule, and Chevron's tax liability actually increases in this event. If additional 50-percent factor relief is to be granted, however, staff would urge that relief as

calculated in Column 4 be the specific type of relief granted. This is the only other type of 50-percent-factor-relief recognizing the distinction between income and dividends. To accomplish this result, the Board could either adopt a resolution or amend its previously adopted motion to state that the apportionment factors of the Caltex group are to be included for purposes of determining Chevron's activities in California based upon the ratio of the dividends received to the pre-tax income, as determined under the Revenue and Taxation Code, of the Caltex group.

Staff again wishes to emphasize that the type of relief granted by the Board, and the basis for this relief, will be cited by other taxpayers as precedent for relief in their circumstances. This issue is already being faced by the department's field audit staff. As the attached schedule illustrates, a number of alternatives exist. For this reason, staff respectfully requests that the Board consider staff's request for clarification of its action on the Chevron petition.


Chief Counsel

Attachment

cc: Marcy Jo Mandel
Marcus Frishman
Bruce Tollner
Gail Miller
Annette Porini
Connie Squires

bcc: Executive File
Chief Counsel's File
Benjamin F. Miller

Mr. Jeffrey M. Vesely
Pillsbury Winthrop LLP
P.O. Box 7880
San Francisco, CA 94120-7880

Alternative Tax Computations

	100% Combination	50% Combination	Per FTB Notices	Proportional 50% Factors	Chevron 50% Factors (T/P Exhibit 45)	Elimination of Dividends & Factors
IYE 12/92	36,360,665	31,199,275	29,078,530	27,528,990	27,463,222	25,126,963
IYE 12/93	39,214,567	34,052,447	32,597,528	30,658,929	28,881,483	28,262,363
IYE 12/94	21,863,431	16,088,613	15,421,556	14,137,353	13,685,671	8,909,074
IYE 12/95	44,021,384	36,666,968	34,818,610	32,435,624	31,414,179	26,297,035
Total	141,460,047	118,007,303	111,916,224	104,760,896	101,444,555	88,595,435
	*	*		*	*	*

* For comparison purposes, the "Applicable Adjustments to Calif. Income" and "Contributions Adjustment" are the amounts used in the department's Notices. This follows the technique employed by Chevron in Exhibit 45. Depending upon the actual method chosen, these amounts will vary slightly.



PILLSBURY WINTHROP^{LLP}

50 FREMONT STREET SAN FRANCISCO, CA 94105-2228 415.983.1000 F: 415.983.1200
MAILING ADDRESS: P. O. BOX 7880 SAN FRANCISCO, CA 94120-7880

September 13, 2001

Jeffrey M. Vesely
415.983.1075
jvesely@pillsburywinthrop.com

VIA CERTIFIED MAIL – RETURN RECEIPT REQUESTED

Doctor Kathleen Connell
State Controller
600 Corporate Pointe, Suite 1150
Culver City, CA 90230

Mr. Claude Parrish
Chairman
State Board of Equalization
680 W. Knox Street, Suite 160
Torrance, CA 90502

Mr. Timothy B. Gage
Director
Department of Finance
915 L Street
Sacramento, CA 95814

Re: Chevron Corporation - Tax Years 1992-1995
Revenue and Taxation Code Section 25137 Petition

Dear Doctor Connell, Mr. Parrish and Mr. Gage:

This letter is in response to the August 15, 2001 memorandum from Brian W. Toman to each of you in the above matter. In the memorandum, FTB Staff is requesting clarification of this Board's decision rendered on June 27, 2001 to grant Chevron's Section 25137 Petition. For this Board's convenience, a copy of the Transcript of the June 27, 2001 hearing is enclosed.

In its memorandum, Staff is simply rearguing its position that factor representation is not warranted in this matter—a position which was rejected by this Board at the June 27, 2001 hearing. All the arguments being put forth by Staff in its "request for clarification" were previously raised and rejected by this Board.

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As was noted in Chevron's comprehensive written submissions and oral argument, Staff cannot have it both ways. Either the Caltex dividends, which represent approximately 21 percent of Chevron's business income, are excluded from Chevron's net income, or the Caltex companies' underlying income-producing factors must be included in the apportionment formula. This Board, in a ruling which needs no clarification, agreed.

"CHAIR CONNELL: Let me try to move where I'm going to be. I don't know if I have a second for this – or maybe I have unanimous support for it. Who knows? I'm going to support granting Chevron's petition for relief. The Caltex companies are clearly part of Chevron's worldwide integrated oil businesses. And the standard allocation apportionment provisions do not, in my view, fairly reflect Chevron's business operations in California, where over 20 percent of Chevron's income is from these foreign operations.

I, therefore, move that we adjust the formula to include 50 percent of the Caltex factors to better reflect Chevron's business in California.

MEMBER PARRISH: Second.

CHAIR CONNELL: Okay, it's been moved and seconded.

Do you have any comment on that, Annette?

DEPUTY MEMBER PORINI: I am opposed to that.

CHAIR CONNELL: Okay, so we had a 2 to 1 vote –

MEMBER PARRISH: In support, yes.

CHAIR CONNELL: -- in support of that arrangement. All right.
(Emphasis added.) (Transcript, pp. 120-121)

Obviously, there is no need for clarification. This Board could not have been clearer. "50 percent of the Caltex factors [were to be included in the formula] to better reflect Chevron's business in California."

In Chevron's Petition (pp. 2-3, 99-101, Exhibits 43-45), its Reply to FTB Staff Summary and Recommendation (page 7), and at the June 27, 2001 hearing (Transcript pp. 102-104), Chevron argued that under Section 25137 either a 75 percent dividend received deduction should be granted for the Caltex dividends or 50 percent of the Caltex factors should be included in the apportionment formula. The respective tax effects were

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provided. The factor relief which this Board granted was straightforward and is depicted in Exhibit 45 to the Petition.¹

Staff is disingenuous in arguing that it does not understand this Board's ruling. In Chevron's returns for the years at issue, Chevron included the Caltex dividends in business income and included 50 percent of the Caltex factors in the apportionment formula. This is consistent with Exhibit 45 and with this Board's June 27, 2001 ruling. Contrary to Staff's assertions, these returns were audited by Staff and adjustments reversing Chevron's inclusion of the Caltex factors in the formula were made.

Staff's assertion that Chevron already obtained "relief" in the form of the notices of proposed assessment is ludicrous. As was noted in Chevron's written submissions and oral argument, the Caltex companies are not partnerships. They are a series of 50 percent-owned corporations. Staff wants to include as business income the foreign source dividends generated by the overseas activities of the Caltex companies, but wants to ignore the activities of the Caltex companies in Indonesia and the Eastern Hemisphere which generated those dividends. The inclusion of the Caltex dividends without the Caltex factors fails to reflect a reasonable sense of how and where Chevron earns over 20 percent of its income. This Board properly concluded that, contrary to Staff's position, the standard apportionment formula does not fairly reflect Chevron's business operations in California.

Staff's thinly veiled attempt to reargue this case must be rejected. Likewise, Staff's request for clarification must be denied.

Chevron respectfully requests that this Board issue a formal written resolution reaffirming its decision rendered on June 27, 2001.

¹ Staff's statement that Exhibit 45 and Chevron's hearing exhibit are not consistent is in error. Both reflect the inclusion of 50 percent of the Caltex factors. Exhibit 45 reflects the FTB's audit adjustments, while the hearing exhibit uses Chevron's original return numbers.



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If you or your staff have any questions, please do not hesitate to contact me.

Very truly yours,

Jeffrey M. Vesely

Enclosure

cc: Ms. Marcy Jo Mandel w/enc.
Mr. Marcus Frishman w/enc.
Mr. Bruce Tollner w/enc.
Ms. Gail Miller w/enc.
Ms. Annette Porini w/enc.
Ms. Connie M. Squires w/enc.
Mr. Brian W. Toman w/o enc.
Mr. Jon Jensen w/o enc.
Mr. Alexander P. Ashford w/o enc.